

MINUTES OF THE
NEW MEXICO EDUCATIONAL RETIREMENT BOARD
INVESTMENT COMMITTEE

April 9, 2009

CALL TO ORDER

A meeting of the New Mexico Educational Retirement Board Investment Committee was called to-order on this date at approximately 1:25 p.m. in the Educational Retirement Board Room, 6201 Uptown Boulevard, N.E., Ste. 203, Albuquerque, New Mexico.

A quorum was present, as follows:

Members Present:

Mr. Bruce Malott, Chair
Mr. Gary B. Bland
Ms. Jan Goodwin

Members Excused:

Mr. James B. Lewis

Other ERB Members Present:

Mr. H. Russell Goff
Dr. Beulah Woodfin

Legal Counsel Present:

Mr. Chris Schatzman

Staff Present:

Mr. Mark Canavan, Portfolio Manager [teleconference]
Mr. Bob Jacksha, Chief Investment Officer
Ms. LeAnne Larrañaga-Ruffy, Investment Officer
Mr. Steve Neel, Portfolio Manager
Mr. Jeff Riggs, Deputy Director
Mr. Greg Trujillo, IT Director

Others Present:

Mr. Allan Martin, NEPC
Mr. Steve Gruber, ORG Real Property [teleconference]
Ms. Michelle Aubel, LFC

APPROVAL OF AGENDA

Ms. Goodwin moved approval of the Agenda, as published. Mr. Bland seconded the motion, which passed by voice vote.

APPROVAL OF MINUTES: March 12, 2009

Ms. Goodwin moved approval of the March 12 Minutes, as submitted. Mr. Bland seconded the motion, which passed by voice vote.

FEBRUARY FLASH REPORT

Mr. Jacksha reported that the Fund was down 4.92% for the month of February and down 31% for the 12-month period. He said Equities were down across the board in International, Domestic, Small Cap and Large Cap, and most of the Fixed Income accounts were also down with the exception of Beach Point, which posted a 1.80% return for the month. He commented that the one bright spot for the month (reflecting January performance) was in hedge fund-of-funds at 3.4%. He said February would also be positive.

Mr. Jacksha said March performance figures will be significantly improved over February, and estimated that total assets were up about \$400 million at this point.

REAL ESTATE—ORG SECONDARY FUND

[Mark Canavan and ORG Real Property manager Steve Gruber were present by teleconference.]

Ms. Larrañaga-Ruffy reported that the New Mexico Secondary Opportunity Fund, anticipated to be \$50-\$100 million, has the objective of acquiring limited partnership interest in global real estate, natural resources and infrastructure funds from distressed sellers at opportunistic pricing. She said the preferred return is 10% with a very friendly fee structure (detailed in materials distributed at this meeting by staff and NEPC).

Ms. Larrañaga-Ruffy said staff recommends a \$25 million commitment. She said NEPC reviewed this commitment for the ERB and Arizona Public Safety.

Mr. Martin stated that Arizona Public Safety received exactly the same proposal from ORG. He said their board was interested, because 1) it was a proposal for an

advisor to do additional work and they were well qualified to undertake that activity, and 2) the fee was extraordinarily good because in theory they could have done a search to see if this was the best possible product in the market. He said NEPC looked at those factors, reviewed all of the PPMs and documents, and deemed ORG well qualified to do this and that the fee was a very good one.

Mr. Gruber said Arizona approved an initial allocation of \$40 million.

Mr. Malott asked how long the timetable for this investment strategy would be, and Mr. Gruber responded that ORG has structured a two-year investment period, given their positioning as a "super opportunistic investor" and their uncertainty as to how big the universe of opportunities might be.

Mr. Malott asked if leverage would be used, and Mr. Gruber responded no. He clarified that they will pay cash for the fund interests that they buy, and the fund interests often include leverage. He said ORG is not planning to put leverage on top of leverage already embedded in the fund.

Mr. Malott asked what is the likely leverage that these funds have with existing properties, and Mr. Gruber responded that a fund with a 2006 or 2007 vintage year was likely 60% to 70% (and sometimes 80%) levered at that time, so on a mark-to-market basis some funds are 100% leveraged on a current value basis. He said ORG has to carefully pick through this universe, where many partnerships (if they are recent) are leveraged not only at the property level but also at the fund level and then also have recourse guarantees and obligations on top of that.

Mr. Malott asks how the ERB gets a good deal as an investor if a partnership is 80% levered and now they are 100% levered because of the changes in the market value of the underlying asset.

Mr. Gruber responded that either the investor would pay ORG to take that interest or ORG would not participate. He stressed the ORG is passing on "an awful lot" of possible deals.

Mr. Canavan agreed. He said staff recently looked at a deal that was 70-80% levered and now is underwater because of the market correction. He said they are passing on many recent vintage deals.

Mr. Gruber added that there is a fund out that bought a public hotel company at a fairly high equity multiple; and when ORG went the pricing of the equity of the fund, it attributed zero value to the hotel company.

Mr. Malott said he wanted to be sure there was clarity around the risks and the opportunity, since this is a different kind of investment: when ORG makes an

investment in a 100% levered deal, the seller will bring cash to the table for ORG to take over the future liabilities and the capital.

Mr. Gruber responded that this was correct, that this could happen.

Ms. Goodwin moved that the Investment Committee approve a commitment of \$25 million plus fees and expenses to ORG NM Secondary Opportunity Fund, L.P., subject to and contingent upon New Mexico state law, Educational Retirement Board policies, and negotiation of final terms and conditions and completion of appropriate paperwork.

Mr. Bland seconded the motion, which passed by voice vote.

ALDUS/NEPC PRIVATE EQUITY ADVISOR ROLE

Mr. Jacksha stated that, given the situation with Aldus Equity and their New York client and the press around that, ERB staff felt it prudent to suspend operations both on the advisory side and with the Co-Investment Fund with Aldus pending a review. He said the ERB is looking into hiring an outside third party to conduct that review.

Mr. Schatzman said he was looking at a two-part review, using a due diligence company and an outside law firm, to look at a process by which the ERB will do due diligence on Aldus and recommend action, as well as to look at how the ERB conducts its due diligence with other advisers. He stated that a scope of work should be ready next week.

Mr. Jacksha said staff has asked NEPC to step in and take over in order to avoid any disruption in the ERB's private equity program,

Dr. Woodfin asked if the ERB has options it can exercise when an adviser under contract is found to be in violation of certain regulations.

Mr. Jacksha responded that all of the ERB contracts include a provision for termination of the agreement within 30 days for any reason.

Dr. Woodfin said her concern was whether the ERB could recover any lost funds.

Mr. Bland explained that the question was whether or not Aldus violated SEC law in terms of disclosing that they hired a third party marketer.

Mr. Schatzman added that there is a civil action in this case involving other parties, not Aldus, but in the civil action there are allegations related to Aldus's

behavior. He said there is a criminal indictment by the New York attorney general that involves the parties named in the SEC action.

Mr. Schatzman also stated that the ERB will be looking at not only its due diligence process but also its contracts and what kind of notice it will require from the adviser. In this instance, he said, the ERB learned about the Aldus issue through a third party, as did the SIC. In addition to the disclosure issue, he said the ERB will also look into whether there are any regulatory sanctions in terms of "don't do this again."

Mr. Schatzman stated that unwinding the investments is another aspect to look at in the event of any losses.

Mr. Malott expressed concern that the ERB approach this fairly and look at the issue globally.

Mr. Schatzman assured the Committee that staff is not going into this with a preconceived notion of a result; rather, they want to look at the processes on the business side and the legal side and apply the lessons they have learned from this experience to contracts in the future.

Mr. Malott commented that, once staff does this and passes judgment on a particular vendor, if staff doesn't have a consistent methodology to continue to do it, staff will never know whether that vendor, subsequent to doing the contract with the ERB, ever had any issues—so there has to be an ongoing obligation that continues for disclosure. He also pointed out that an admonishment from a regulator does not automatically mean someone is a "bad firm" just because they have been sued, for instance.

Mr. Jacksha asked Mr. Martin to discuss NEPC's proposal for private equity services to the ERB.

Mr. Martin stated that Mr. Jacksha and Mr. Neel approached NEPC and asked them to assume the duties of Aldus during an interim period so the ERB would not lose momentum, and any outstanding research that Aldus had done could be picked up and revalidated to make sure there was nothing inappropriate with respect to those investments.

Mr. Martin said NEPC's procedure is not dissimilar to Aldus's. He said he was comfortable that NEPC could serve in this role well for the ERB because their senior private equity specialist, Bill Monagle, is familiar with the Aldus plan and the individual investments that have been made.

Mr. Martin stated that, if the Committee and Board want to move ahead with the NEPC proposal, Mr. Monagle would spend the day with staff and review the

existing plan, revalidate it, develop any modifications, and continue the program for the time period desired.

Mr. Martin said that Mr. Monagle is considered in the marketplace to be one of the best private equity professionals around.

Mr. Neel said he was comfortable with this choice, noting that staff worked with Mr. Monagle extensively when they underwrote the coinvestment. He added that Mr. Monagle is considered a dean in the private equity world and he has a great deal of respect for him.

Mr. Jacksha indicated that he was very comfortable working with Mr. Monagle.

Mr. Jacksha also stated that he would like to take a look at the strategic plan and consider some modification given the extraordinary circumstances in the marketplace, with the idea that this is an ongoing program with regular investments and without attempts to time the private equity market. He said there may be one sector or another where there can be more or less emphasis for the rest of this year, while still remaining close to the original plan.

Mr. Malott said he was comfortable with that, but wanted to make sure there was a methodology, because he always felt comfortable that Aldus was following that through their monthly Allocation Plan.

Mr. Neel responded that this is an opportunity to incorporate best practices. He said staff has incorporated a number of them from Aldus and will be able to take some pieces from NEPC and the external adviser.

Mr. Neel and Mr. Jacksha reviewed the following duties proposed by NEPC for a period of six months:

- 1) Review and update the NMERB Private Equity plan.
- 2) Review and revalidate (or reject) all pending existing proposed Private Equity allocation recommendations.
- 3) Work with Investment Committee and Staff to identify and propose new Private Equity commitments consistent with Private Equity Plan and allocation targets.
- 4) Conduct analysis and prepare and report on the performance of the existing Private Equity portfolio.
- 5) Other duties as identified by the Investment Committee or staff to fulfill this obligation.

With respect to the second item, Mr. Neel said three investments have been approved by the Investment Committee but have not been executed: Sevin Rosen, NGP and Lexington Partners.

Mr. Neel stated that Aldus is being paid \$750,000 annually, paid quarterly, in arrears.

Mr. Jacksha said the six-month contract with NEPC would be for \$300,000, subject to cancellation if they are not needed for the entire period.

Mr. Bland moved that NEPC be adopted as the interim private equity adviser based on NEPC's written proposal as presented.

Ms. Goodwin seconded the motion, which passed by voice vote.

INVESTMENT POLICY RATING CONSIDERATION

Mr. Jacksha stated that the ERB's Investment Policy contains appendices or exhibits for each investment manager that outlines the allowable investments. He said that, for at least one of the fixed income managers, it has a ratings requirement that says all investments will have a rating of BBB- or better.

Mr. Jacksha stated that one manager approached the ERB and said they had a mortgage-backed security that had fallen precipitously. Mr. Jacksha said there would be some loss on this security, but right now it is trading at 10 cents on the dollar and the manager is saying the ultimate value is much better than that and is asking to hold it.

Mr. Jacksha said the policy is unclear. He said that, in some cases, the ERB has clearly stated at the time of purchase that the investment has to have a BBB rating, but the policy is actually silent on that and doesn't say something has to be sold or has to be held.

Mr. Jacksha stated that he would prefer that the ERB allow the manager to hold it, since it makes sense not to force a sale when something has been beaten down.

Mr. Jacksha said SIC policy was written specifically to say "at the time of purchase," and many times something wasn't sold when it was downgraded, and it did ultimately recover.

Mr. Goff asked if the procedure would have to be rewritten, and Mr. Jacksha responded that he did not think so—this was just an interpretation of the language.

Mr. Malott expressed concern about micromanaging what a manager has to do. He said he would agree that they should be permitted to do their work, and if they don't do it well, the ERB can hire another manager.

Mr. Jacksha said this item was on tomorrow's Board agenda, and asked the Committee to approve staff's recommendation.

Mr. Bland recommended that the Board resolve that the language in regard to ratings on fixed income securities is at the time of purchase.

Ms. Goodwin seconded the motion, which passed by voice vote.

INVESTMENT MANAGER FEES

Mr. Jacksha stated that Ms. Goodwin and staff have been talking to a number of managers about renegotiating fees, saying that the ERB wants to lower fees, is willing to pay performance fees over hurdles, and is asking the managers to present proposals.

Mr. Jacksha stated that one manager, Wells Fargo, has said no, and would not negotiate at all, and is on tomorrow's Board agenda for termination.

Mr. Jacksha said Wells has had very good performance lately but not very good performance since inception.

Mr. Jacksha stated that a number of managers were reluctant, but eventually came around with a proposal.

Mr. Jacksha said he was also recommending that the Board terminate Mellon, which presented a proposal but then didn't respond after staff asked them to go back and come up with something better.

Mr. Jacksha stated that Mellon's performance has also been very bad.

Mr. Jacksha said the assets would be shifted to existing managers. He said the Wells assets would be shifted to Perimeter, another small cap manager.

Mr. Jacksha stated that a third manager, Beach Point, said they could only do this if the ERB were an investor in a private equity fund, since in the other funds they have an MFN. He said he has asked them to send in a proposal, and so that is pending.

Mr. Jacksha said all of the others came in with fees that were no more than 50 basis points on a flat fee plus performance—that was the highest—and most were around 25-35 basis points, and some were even lower.

Mr. Jacksha commented that he and Ms. Goodwin agreed that they were satisfied that these were better structures overall, and they will especially be better through underperformance. On the other hand, he said, it is important to recognize that if there is very good performance the ERB will pay them more than under the current structure.

Mr. Martin said he wanted to emphasize that the structure of performance fees is an industry standard, so if the normal fee on the current schedule is 75 basis points for a small cap manager, when they go to a performance fee they say they will earn the 75 basis points at a level of outperformance—for instance, 100 basis points. If the ERB says they want a base fee of 25, he said, for every percent of outperformance against the index, there is a slope that at 100 basis points of outperformance results in their normal fee. He said that line extends up to a maximum fee, so in theory if the manager truly generates 100 basis points of outperformance at the normal fee, the ERB isn't getting any deal at all because some of the time they will do better and the ERB will pay them more, and then the ERB will pay them less when they don't do so well.

Mr. Martin said managers rarely achieve the degree of outperformance consistent with their normal fee, so the ERB is probably on average will do better under this structure. He added that, given what the market has been through, if the manager is ever going to outperform it will probably be in the next year or two—so it is possible that, for the next year, these fees might actually produce a higher fee than the ERB is currently paying.

Mr. Bland said the SIC pays its managers a flat 25 basis points, and the active managers are up 11% year to date.

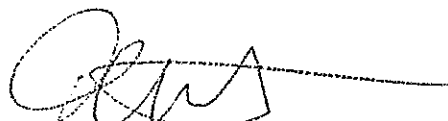
OTHER INVESTMENT REPORTS

Mr. Malott stated that Mr. Lewis has resigned from the Investment Committee, and he is recommending that Mr. Goff be appointed as his replacement.

ADJOURN

Its business completed, the Investment Committee adjourned the meeting at approximately 2:15 p.m.

Accepted by:

A handwritten signature in black ink, appearing to read 'B. Malott', written over a horizontal line.

Mr. Bruce Malott, Chair